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BY THE COMPTROLLER GENERAL

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The Federal Reserve Should Move Faster To Eliminate Subsidy Of Check Clearing Operations

SUMMARY

The Monetary Control Act of 1980 required the Federal Reserve to begin charging in 1981 for selected services that used to be provided free to member banks. This report examines how the Federal Reserve implemented pricing for clearing checks and for clearing payments electronically--two services that together account for more than one-third of the operating budgets of Federal Reserve banks.

In establishing a system for pricing its services, the Federal Reserve generally made reasonable judgments in exercising the wide discretion given it by the Monetary Control Act. GAO believes, however, that the Federal Reserve Board could be moving more quickly to achieve the Monetary Control Act's longrun objective of pricing services without subsidy. GAO recommends actions which would increase the Federal Reserve payment to the U.S. Treasury by as much as $175 million in each of fiscal years 1982 and 1983. These actions would also enhance the ability of private sector institutions to compete with the Federal Reserve on a more equal basis.

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COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

THE FEDERAL RESERVE SHOULD MOVE FASTER TO ELIMINATE SUBSIDY OF CHECK CLEARING OPERATIONS

D I G E S T

In 1981, pursuant to a major policy change mandated by the Monetary Control Act of 1980, the Federal Reserve began charging financial institutions for certain services that used to be provided without cost to member banks. This report focuses on how the Federal Reserve implemented pricing for clearing checks and accomplishing fund transfers through an automated clearinghouse system. GAO undertook this study to determine whether the Monetary Control Act's long run objective of pricing services without subsidy was being achieved in as timely a manner as practicable.

The Federal Reserve System clears about 40 percent of all checks written in the United States. In 1980, the Federal Reserve spent almost $280 million clearing about 14 billion checks at an average cost of about 2.0 cents per check. Expenditures for Federal Reserve check clearing activities, which involve 48 offices connected by air courier and wire services, accounted for about 35 percent of the entire Federal Reserve banks' expenditures in 1980. Expenditures for the Federal Reserve's much smaller automated clearinghouse system were about $16 million in 1980.

RECOMMENDATIONS

In establishing a system for pricing its services, the Federal Reserve generally has made reasonable judgements in exercising the discretion given to it by the Monetary Control Act over when and how to price specific services. However, GAO believes the Federal Reserve should take these actions to establish as soon as practicable a price structure for its clearinghouse operations that fully recovers costs:

(GGD-82-22)

--Eliminate promptly the subsidy in the check clearing area that has arisen due to declining check processing volume and rising expenses. (See p. 39.)

--Establish a definite timetable for pricing float (an interest-free advance to financial institutions which arises during the check collection process when the reserve account of a depositing bank is credited with funds before those funds are deducted from the reserve account of the paying bank). (See p. 57.)

--Raise the price of automated clearinghouse services. (See p. 68.)

The management actions GAO recommends to help balance check clearing costs and revenues include formal procedures for monitoring performance, revising prices every 6 months, disclosing how revenues compare with expenses, and, if necessary, substantially reorganizing the check clearing function. (See p. 39.) Because the Monetary Control Act is not specific about when float must be priced, GAO does not recommend a specific date.

Clearinghouse operation subsidies are indirectly paid for by taxpayers because the Federal Reserve finances them out of earnings that otherwise would be paid to the U.S. Treasury. GAO estimates that timely Federal Reserve actions to eliminate subsidies could increase earnings paid to the U.S. Treasury by about $175 million for the last half of fiscal year 1982 and also about $175 million for all of fiscal year 1983. Of these amounts, which could be offset by up to 40 percent by reduced income tax collections, approximately $150 million in each period is attributed to fully recovering float costs (see p. 51), about $20 million to eliminating check clearing subsidies, (see pp. 20 and 40), and about $5 million to eliminating automated clearinghouse subsidies (see p. 61). Eliminating subsidies would also provide private sector institutions the opportunity to compete on more equal terms with the Federal Reserve System. (See p. 66.)

The following sections discuss agency comments on the report's recommendations and on GAO's suggestion that the ability of the Federal Reserve

to respond to market forces without reliance on subsidy is an appropriate focus for congressional oversight activities.

SUBSIDIES ARISING FROM DECLINING CHECK CLEARING VOLUME AND RISING EXPENDITURES SHOULD BE ELIMINATED PROMPTLY

The Federal Reserve assumed that check clearing volume would stay about level with that of the previous year when pricing began in August 1981. However, in the 4-month period ending November 1981, the number of checks cleared by the Federal Reserve declined by 7 percent and the number of checks sorted declined by 17 percent compared to the comparable period of 1980. There has been some effort to trim expenses to offset the volume decline, but the Federal Reserve is also increasing expenditures in some areas. As a result, GAO estimates that check clearing is now being subsidized at an annual rate of about $40 million to $50 million. (See p. 20.)

In commenting on GAO's draft report the Federal Reserve suggested that the volume decline has been a "one time" occurrence and indicated its intention to match check clearing revenues and costs, to undertake reporting of information that would facilitate this, and to review fee schedules at least annually. GAO believes that a commitment to review prices every 6 months would be practical and would enable the Federal Reserve Board to minimize subsidies. At the current rate of subsidy, putting off major revision of prices until August 1982, the anniversary date on which pricing for this service began, would cost about $20 million in fiscal year 1982. Because GAO believes that forecasting volume for 1983 may be more difficult than the Federal Reserve Board suggests, avoidable subsidies of a comparable amount are likely to occur in fiscal year 1983 if major price revisions are undertaken only once per year. (See p. 40.)

GREATER COMMITMENT TO RECOVERING THE COST OF FLOAT IS NEEDED

The daily amount of float now averages about $2.5 to $3.0 billion. The cost of interest

Contents

		Page
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	How the Federal Reserve clears checks	1
	The Federal Reserve's market share	4
	Pricing provisions of the Monetary Control Act and how they have been implemented	5
	Objectives, scope, and methodology	7
2	THE CHECK CLEARING SYSTEM NEEDS TO BE WELL MANAGED TO AVOID SUBSIDIES	12
	The initial prices for processing paper checks were designed to cover full costs	12
	Check processing volume is below what was forecast when prices were set	15
	Declining volume and rising costs are resulting in service subsidies	20
	Options available for eliminating subsidy of the Federal Reserve's check clearing system	21
	Specific management steps needed to control subsidy of check clearing activities	34
	Conclusions	38
	Recommendations	39
	Agency comments	40
3	THE FEDERAL RESERVE SHOULD EXPEDITE EFFORTS TO RECOVER THE COST OF FLOAT	42
	Float is an interest-free advance to banks	42
	Federal Reserve actions to recover the cost of float	44
	Operating improvements being considered will reduce float further but will not eliminate it	47
	GAO expressed concern with the float-pricing delay in a March 1981 letter to the Federal Reserve	48
	Pricing float can complement future efforts to achieve efficiency through operational improvements	49

PSAF	The private sector adjustment factor used to increase Federal Reserve costs to reflect taxes and cost of capital that would be incurred if the Federal Reserve were a private sector corporation
RCPC	Regional check processing center